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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

The British Economy on the Eve of the Nixon-Heath Meeting

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
December 1971

INTELLIGENCE MEMORANDUM

THE BRITISH ECONOMY ON THE EVE
OF THE NIXON-HEATH MEETING

Conclusions

1. The United Kingdom is presently experiencing stagflation -- a condition of little or no economic growth accompanied by a high inflation rate. The number of unemployed is the largest in more than a generation, while retail prices have increased by 10% in 1971. After a lackluster performance in 1970, real gross national product (GNP) actually fell in the first half of 1971. Ironically, the foreign payments position has strengthened -- partly as a result of the past year's domestic economic doldrums. Import demand has been below what it would otherwise have been while export sales have been good. As a result, the traditional trade deficit has changed to a surplus this year, and trade prospects for 1972 are encouraging.

2. The domestic economic outlook is less clear. There are signs that a recovery is under way, but not as vigorous as London would like. Consumer and investor confidence has yet to be restored, and much uncertainty remains concerning inflation and the impact of entry into the European Community (EC). The US monetary and trade measures instituted in August have not been much of a factor in the British economy's poor performance, and the reforms sought by Washington probably will not greatly affect Britain's rate of economic recovery in 1972. Indeed, short-term capital inflows have pushed UK international reserves to record levels.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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Discussion

The Domestic Sector

3. The term stagflation accurately characterizes the UK economy in 1971. Indeed, sluggish growth and retrenchment have been the order of the day since mid-1970. After a below-capacity growth rate of only 2.1% in 1970, real GNP fell slightly during the first half of 1971. In January 1971, average hourly wage rates were 14.2% higher than a year earlier, and during most of this year's first three quarters retail prices advanced about 10%. Inflation has moderated slightly since this past summer, but this small improvement could be vitiated by vigorous union bargaining this winter and next spring. Strikes of dock, automobile, and postal workers contributed to the economy's sluggish performance during 1971. Other factors have been the working down of inventories and reduced capital spending generally.

4. Continuing slack domestic demand and increasing labor costs resulted in a profit squeeze that forced many employers to lay off surplus workers or postpone new hirings during most of 1971. Unemployment -- normally 2%-2.5% of the labor force -- stood at 3% at the beginning of 1971 and increased to more than 4% by early December, when nearly 1 million people -- a 30-year high -- were out of work. Heavy manufacturing in the Midlands was hard hit, with the unemployment rate at more than 5%. Scotland and Northern Ireland suffered even more, with average unemployment at 6% and 9%, respectively, in October. In addition, many other workers were placed on short work weeks, and overtime payments were sharply reduced.

5. Prime Minister Heath's initial strategy against inflation included restraints on public finance. Thus the Conservatives adopted a policy of restricting the public sector's claim on resources and of less direct intervention in the economy when they took office in June 1970. The policy's keystone was keeping the growth of public expenditures below that of the economy. The economy's behavior in early 1970 suggested the need for some government pump-priming; yet the new government raised its spending by only small amounts in 1970 and the first half of 1971.

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6. London did institute some modest reflationary measures this past March and July and again in November. The March steps included a 2.5% cut in corporate taxes and an increase in personal income tax exemptions. In July the government introduced an 18% reduction in sales taxes, stepped up spending on public works projects, and liberalized tax credit, installment buying, and depreciation rules. Measures to speed up spending on previously planned government projects were announced in November. All three sets of measures have been consistent with Heath's philosophy of making revenue reduction rather than new spending, the cutting edge of his fiscal policy. The July measures should have greater impact than those taken in March; there are already indications that retail sales have responded favorably to the sales tax cut. The effectiveness of the other measures will not become apparent until well into 1972, and then only gradually.

The Foreign Sector

7. The current account of the UK balance of payments continued to strengthen during 1971. For the first three quarters of 1971, the current account surplus was about \$1.6 billion - nearly 70% more than in the same period of 1970. The improvement in the trade balance was striking. The United Kingdom traditionally imports more than it exports, but this situation was reversed in 1970. Exports of goods and services during the first three quarters of 1971 totaled \$15.7 billion (13% higher than during the same period in 1970), while imports were \$15.3 billion (up 10% over 1970). There consequently was a trade surplus exceeding \$400 million.

8. Several factors are responsible for the United Kingdom's unusually favorable balance-of-payments position in 1971. First, slack domestic demand kept imports from increasing as much as they might have otherwise. Second, a rise in world trade in 1971 has kept demand for the United Kingdom's exports strong. Finally, net "invisible" earnings have continued high. Britain's official debt has been reduced, and the inflow of invisible earnings from banking, shipping, tourism, insurance, and foreign investments has been good.

9. There is no clear evidence that the US monetary and trade measures instituted in August 1971 have yet had more than a minimal impact on the United Kingdom's foreign trade. Exports to the United States dropped sharply during November, but this was largely due to the US dock strike. Although government and business spokesmen voiced increasing criticism of the US trade measures during October and November, only about 8% of the United Kingdom's exports are affected by the import surcharge. Moreover, most of these exports are either luxury items, the demand for which is relatively insensitive to price changes, or engineering products that are highly specialized and not easy to substitute for in the short run.

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10. The months of monetary uncertainty following the US announcement do not appear to have significantly deepened or prolonged the economy's slump. The slump started long before 15 August, and present consumer and investor uncertainty is much more closely related to inflation, Common Market entry, unemployment, and the government's hesitant reflationary policy than to conditions in the foreign sector, which is performing well.

11. International monetary reserves have increased sharply during 1971 to a record \$5.6 billion in November, an increase of \$2.8 billion over the end of 1970. Apart from the current account improvement, Britain received a massive inflow of funds associated with continuing overseas confidence in sterling, the tight domestic monetary policy, and a high level of international liquidity. The capital inflow has continued at a high rate even since August, when the pound began to float in currency markets. The economy's strong foreign trade performance and London's traditional role as a reserve center for the sterling area, are generating upward pressure on the pound, however, and Bank of England intervention in the foreign exchange market - creating a so-called "dirty float" - has been provoked by large inflows of short-term capital.

Economic Problem Areas

12. The most important impediment to Britain's recovery from its current recession is a widely held feeling of uncertainty on the part of both consumers and investors. Some of their uncertainty is related to the feared economic impact of joining the EC. Although the government has been extolling the advantages of an expanded market for British producers, some firms have been holding back their spending until the necessary enabling legislation is enacted and they are in a better position to assess the effect on British exports. It will probably be six months to one year before they will be able to appraise confidently their EC opportunities and be willing to make firm investment plans. Consumers, for their part, are not sure how entry will affect their standard of living.

13. Consumers and investors are also uncertain about the future course of inflation. Although increases in wages and prices moderated slightly this fall, the inflation rate remains unacceptably high. There are some signs that the government may have at least turned the corner on this problem, however. In July the Confederation of British Industries (CBI) obtained a commitment from 200 large firms either to try to forgo price increases or limit them to a 5% annual rate until July 1972. Moreover, in recent weeks Britain's Trades Union Congress has shown signs of becoming more cooperative in seeking more moderate wage settlements.

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The government has set its sights on reducing wage increases to 7%-8.5% yearly this winter, whereas earlier this year increases averaged 10%-14%.

14. Rising unemployment has probably now replaced inflation as the government's main economic problem. Although the present 4% rate may not appear inordinately high compared with recent US rates of some 6%, much of the difference reflects the fact that the United Kingdom defines unemployment much more restrictively -- measured in US terms, the UK rate would be about 5%-5.5%. Labor unions are becoming increasingly bitter over the sharp increases that have followed month after month. When the government announced in late November that unemployment had reached 4%, 10,000 workers staged a disorderly protest outside Parliament and union leaders met with Prime Minister Heath to demand a \$2.4 billion increase in spending to stimulate the economy.

Prospects for 1972

15. Forecasters are predicting that 1972 will bring a moderately paced recovery. The government officially forecasts a real growth rate of 4%-4.5% during the first half, led by increases in consumer spending -- especially for durables. The National Institute for Economic and Social Research (NIESR), the country's leading private forecaster, recently predicted a growth rate for all of 1972 of 4%, compared with an estimated 1% for 1971. NIESR foresees increases in both personal consumption and exports of 4.3%.

16. In view of the mixed economic news in recent months, both forecasts may prove to be overly optimistic. Both assume that consumers and investors will react positively to the government's reflationary measures. Although consumer spending seems to be picking up, bad economic news could depress spending and hold the recovery below the forecast rate. The latest CBI survey shows business confidence picking up, with more investors expecting an upturn than a downturn. The survey also indicates, however, that most investors expect to invest less in 1972 than they did in 1971.

17. If consumer and investor spending in early 1972 are much below the forecasters' targets, the government probably will step in with still more reflationary measures. Heath's conservative attitude toward government spending and counter-cyclical fiscal policy appears to be changing to a reluctant willingness to use the budget to help get the economy moving. The reflationary measures taken in March, July, and November should raise public spending by 4% in the fiscal year ending March 1972.

18. Because changes in the unemployment rate tend to follow rather than lead changes in output and sales in the United Kingdom, it is likely

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that substantial unemployment will remain a problem throughout 1972, whatever reflationary steps are undertaken. The rate will probably remain above 3.5%, even in the face of a moderate pickup in domestic demand.

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19. The outlook for substantial improvement on the inflation front next year is not as bright as that for output. Although inflation is no longer increasing, it remains high. Retail prices were 9.4% higher in November than a year earlier, and the informal pricing agreements among government, business, and labor will probably not soon bring about a significant reduction in the inflation rate.

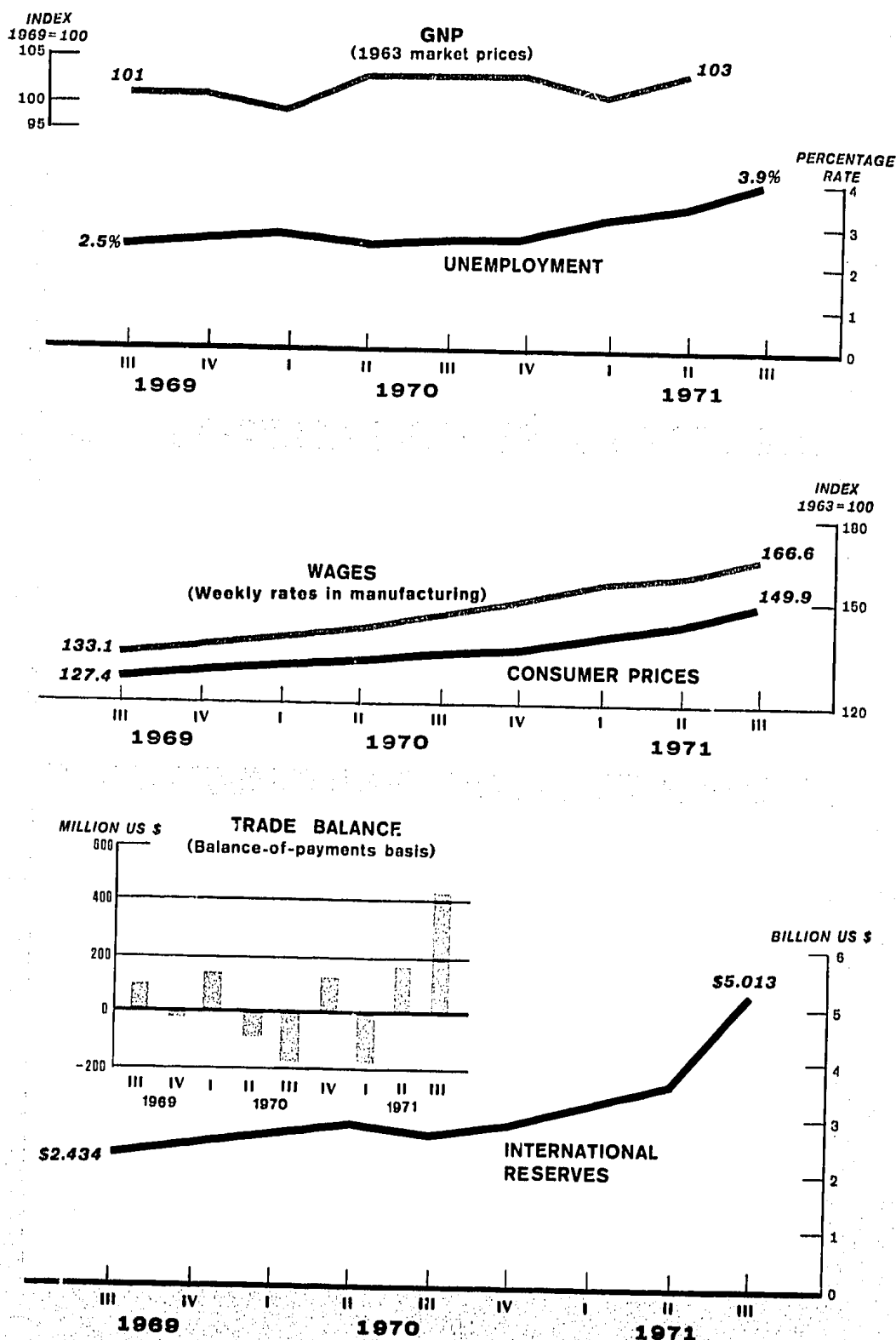
20. The balance of payments should remain strong in 1972. The expected improvement in domestic demand will increase imports somewhat, but strong export growth is projected to continue, at least through the first half of 1972. NIESR forecasts a current account surplus of about \$2.3 billion, or about the same amount as is anticipated for 1971.

21. Settlement of international monetary difficulties probably will not greatly influence the pace of Britain's economic recovery. To be sure, an early settlement on terms favorable to the British would help to revive confidence, but its other effects would be felt only gradually over a period of years.

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